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IRS Cracks Down: Reporting Crypto and NFTs on Your 2020 Taxes

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Online brokers and trading platforms have made access to crypto exchanges a standard feature over the past few years, and the IRS has responded to the resulting surge in ownership with updated reporting requirements. The 1040 Form for 2020 is the first to specifically ask if the filer has acquired an interest in cryptocurrency in the past year, and the question's placement as the first item on the first page of the form shows the IRS has made crypto a priority. At the same time, the agency has boosted its efforts to uncover unreported digital assets with the creation of its Office of Fraud Enforcement in 2020 and an announcement in March of 2021 that the division had constructed a new investigative team under the name "Operation Hidden Treasure" to identify individuals who fail to report their income from crypto.

With the deadline for filing federal income tax in 2021 extended from April 15 to May 17, now is the time for individuals and businesses, especially those who acquired their first digital assets in 2020, to understand the Internal Revenue Service's reporting requirements and guard against unexpected penalties.

How Crypto is Taxed

It may seem counterintuitive because a majority of these assets can function as money, but capital gains tax applies to all cryptocurrency and NFTs. This means the appropriate tax rate on any income realized will be dependent on whether the gain is classified as short-term or long-term. For individuals, income, marital status, the Net Investment Income Tax, and the applicability of exclusionary rules such as those for assets received as gifts or inheritance will all affect the appropriate rate as well. Conversely, losses from crypto transactions can be used to reduce an individual's taxable income.

Special Rules for NFTs

Interests in Non-Fungible Tokens (or "NFTs") create additional reporting complications. For the uninitiated, an NFT is unique digital asset that utilizes blockchain technology to represent and preserve ownership rights over the asset. Since the beginning of the pandemic, NFTs have skyrocketed in popularity among art and trading card collectors, and their application to other digital investments and physical assets such as real estate is expanding at a rapid pace. Unlike cryptocurrencies, the IRS classifies NFTs as collectibles and they are therefore subject to a higher minimum capital gains tax rate of 28%.

Further, whether one or two taxable events occur during ownership of an NFT depends on whether it was purchased with U.S. Dollars or a cryptocurrency such as Bitcoin or Ether. If the NFT is purchased using dollars or any other fiat money, a taxable event only occurs when the NFT is sold. However, if cryptocurrency is used to acquire the NFT, then an additional taxable event based on the difference in value of the cryptocurrency occurs at the time of purchase as described above.

Given that further crypto regulation has the public support of Treasury Secretary Janet Yellen and bipartisan congressional leaders, Roetzel will continue to monitor developments in this area. For more information and insight on this matter, please contact one of the listed Roetzel attorneys.

IRS and Cryptocurrency Audits

The IRS is focusing on cryptocurrency transactions in its audits. As a general rule, an audit will be conducted by an IRS auditor in conjunction with a specialist (usually out of another office) whose focus is solely on cryptocurrency. The auditor will likely ask for an interview with the taxpayer (lately these are done over the phone) with both the auditor and the cryptocurrency expert present. Either before or after that interview, there will be "Information Document Requests" or "IDRs" issued asking for specific items, depending on what is reported on the tax return.

Items that might be requested are (i) copies of all bank statements for the year in question; (ii) unaltered .csv files of all transactions (sometimes requesting these items since inception); (iii) emails, screen prints, hardcopy prints and transactions receipts; (iv) wire transfer or direct deposit records, including ACH and EFT records; (v) lists of all virtual currency kiosk locations and copies of receipts or acknowledgments; (vi) lists of cryptocurrency transactions involving cash and the cryptocurrency involved; (vii) correspondence of any type with all counterparties; (viii) listing all currencies received from hardforks, faucets, tipping, or other method; (ix) explanation of method used to compute basis, (x) records reflecting valuation of any sale or other disposition.

The list is almost endless of the information they require, and some of which they ask for in electronic format.

What To do If I get the Dreaded IRS Letter?

First, don't panic. Second, call an experienced professional who can help you navigate both the IRS and their audit procedures. The attorneys at Roetzel can assist in negotiating a fair and equitable resolution by guiding you and your accountant through the maze of an IRS audit.

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